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IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

No. 742.

JAMES J. WALSH, UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF CONNECTICUT,
Plaintiff in Error,

vs.

FREDERICK F. BREWSTER.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

APPENDIX TO BRIEF FOR DEFENDANT IN ERROR.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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Extracts from a paper read before the American Economic Association at its thirty-third annual meeting at Atlantic City, December 29, 1920.

by

FRED ROGERS FAIRCHILD,
Professor of Political Economy in Yale University,
entitled,

"FEDERAL TAXATION OF INCOME AND PROFITS."

" * * * A more important and more troublesome problem is that of applying practically the distinc-

tion between income and capital. Income is a service rendered by capital. Increase in the amount or value of capital itself is not income. The distinction between capital and income is not a particularly difficult one in theory. The problems arising from its practical application, on the other hand, are complex in the extreme, and the United States income tax has not succeeded in applying the distinction with any great degree of logic or even of practical success.

On the one hand the distinction is clearly recognized in that gifts and inheritances are regarded not as incomes, but as an acquisition of or an addition to capital. The law expressly recognizes that these additions to capital will themselves in turn yield income which will later be subject to the tax. The law is here in harmony with economic principle.

But suppose capital is increased, not by sudden additions, but by gradual growth in value. Is this increase income? Certainly not, if I have stated correctly the true character of income. This is a question upon which there has been difference of opinion among economists. The issue was fought out at a previous meeting of this Association under the general topic, *Are Savings Income?*[1] I think it is today safe to say that the weight of economic authority supports the theory that mere growth in value of capital is not income. Capital does not render service to its owner by simply growing in size. Presumably it is now capable of yielding a larger service than before, but it is this service which is income, not the increase in the value of the capital. In fact, it is frequently (though not al-

[1] Publications of the American Economics Association, Vol. IX, No. 1, April, 1908.

ways) this very power to yield larger income which has caused the capital to increase in value.

On the whole, the lawmakers have held fairly well to this principle. If land appreciates in value, the increase is not taxed as income so long as the ownership of the land does not change. If a corporation's assets increase in value or its prospects of future earnings improve, the corresponding rise in the value of its shares is not treated as income to the shareholder so long as the ownership remains the same. This is correct. But the situation changes when capital assets are sold or exchanged. In such event the law regards as income the difference between the value of the article on the date when sold or exchanged and its cost, or, if acquired before March 1, 1913, its value on that date. So long as the owner holds his capital its growth in value is generally not regarded as income, but just as soon as he sells it or exchanges it for other property, he must render an accounting, and show a gain or loss; the gain, if any, is income.

This position is clearly illogical, whatever otherwise may be said for it. If growth of capital value is not income so long as the capital is not disposed of, on what grounds can the increase in value be regarded as income simply because a particular piece of capital is exchanged for another of presumably the same value? The transfer presumably makes no change in the value of the owner's capital. No service is rendered to him by his capital on account of the transfer. To treat growth of capital value as income merely because there is an exchange of capital is inconsistent. That such treatment would be likely in certain cases to lead to great injustice is apparently recognized in the law itself, since an exception is made, applying,

however, only to cases where "in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value." In such cases the law prescribes that "no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged." Aside from the reference to "par or face value," which is illogical, this clause of the law represents what I regard as the sound principle to apply to all cases of transfer of capital assets. Why should it be limited to reorganization, merger, and consolidation of corporations? The principle is exactly the same in every case where securities are exchanged for other securities or, indeed, where capital assets of any sort are exchanged for other capital assets. No income is derived on account of the transfer. The presumption is that the value given is the same as the value received, and even if a greater value is received, the result is not income but increase of capital. In this case the gain is of the nature of a gift, and gifts are not regarded as income even in the law.

The matter is perhaps not quite so clear in the case of sales of capital assets. Here the thing received is not another article of capital of the same sort, but money. Yet even here I must confess my inability to find any logical justification for regarding the gain from such sale as income. The owner has simply transferred capital of one form into capital in the form of money. It cannot be said that his capital has yet rendered him a service. It is quite possible that the money will immediately be used in the purchase of

other capital assets of the same general character as those sold. In such case, the owner's capital remains of the same value as before, and it has rendered him no service. But, it may be asked, have we not accepted on practical grounds the legal definition of income as practically money receipts? Should we not say that the owner's capital has rendered him service by bringing in money, and that the money so received is the income? Very good; but if so, it is the entire money proceeds of the sale, not merely the gain, which is income. This would be logical, and there is much to be said for such a construction, if accompanied by the right to offset money expended in the purchase of new capital. To be logical we should either regard the sale of property for money as yielding no income at all, or else we must regard the entire proceeds of the sale as income. I can find no logical ground for regarding as income merely that part of the money proceeds which represents a gain over the cost, or the value on a certain date, of the property sold.

By a somewhat remarkable coincidence, this view has just received support from a decision of Judge Thomas in the United States District Court of Connecticut in the case of Brewster vs. Walsh. The case involved this very point, and the decision, rendered on December 16, 1920, holds "that the appreciation in value of * * * bonds, even though realized by sale, is not income taxable as such." The court concludes that such appreciation is capital, not income, and that a tax imposed upon it is a direct tax and would have to be apportioned among the states according to population. This decision, if sustained, will of course mean a complete reversal of the situation in this respect. Its influence in bringing our income tax law

back to sound fundamental principles will, in my opinion, be second only to that of the decisions of the Supreme Court in the stock dividend cases.

Pending final legal determination of this matter, it may perhaps be a waste of time to discuss a possible compromise. I should, however, like to suggest that, in case this decision should be reversed, the exception which the law now grants for exchange of securities in connection with mergers, etc., should be extended at least to all transfers of property except where there is an actual sale for money or for something so nearly equivalent to money that it can be turned into money without another sale; such, for instance, as a promissory note or a book credit. This I recognize is illogical and a purely practical compromise. But it has the advantage of removing the most serious cases of injustice, and it would simplify greatly the administrative problem.

Of course nothing in the foregoing is intended to interfere with the present practice of determining income of traders and dealers through comparative inventories of stock in trade. There is no reason why this procedure, developed by accounting practice and fairly satisfactory to all concerned, should not continue. Difficulty would occasionally arise in distinguishing a dealer from one who was not in the business of buying and selling goods or capital assets, but this is a matter which could without doubt be taken care of satisfactorily.

While our attention is on the distinction between capital and income, our old friend, the stock dividend, deserves at least a passing word of recognition. I have elsewhere[2] tried to show that, whatever our

[2] Bulletin of the National Tax Association, April, 1918, p. 161; June, 1918, p. 240; April, 1920, p. 208.

theory of growth of capital value, the stock dividend cannot be included in any logical definition of income. It certainly constitutes no service rendered by capital to its owner. It represents nothing given by the corporation to the stockholder. It consists simply in a bookkeeping change in the liability of the corporation to its stockholders; namely, a transfer from surplus to capital. This is not income. But, it may be argued, does not the stock dividend represent a growth in the value of the capital invested in the corporation? Very probably it does, but this growth did not take place suddenly when the stock dividend was paid. The stock dividend did not cause it. It had been going on gradually, for a longer or shorter period, and was shown by the growth in the corporation's surplus. Growth of capital was there already, before the stock dividend was declared, and would have been just as much present if the stock dividend had never been declared. The law must choose one or the other definition. If it choose to define growth of capital as income, it then need pay no attention to the stock dividend, but must periodically ascertain in every case the actual growth in the value of the capital, whether stock dividends have been declared or not. If, on the other hand, the law supports the economic principle that growth of capital is not income, there is no longer even the superficial justification for regarding the stock dividend as income. Fortunately this matter has been definitely settled by decisions of the United States Supreme Court, in a way which agrees I think not only with economic principle, but also with the underlying theory of our income tax law itself.

I recognize that there may be a perfectly reasonable feeling that growth of capital ought to be taxed.

But this is an entirely separate question from whether growth of capital should be treated as income. The fact that inheritances are not subject to the income tax does not mean that we cannot tax inheritances. If growth of capital assets is a proper subject for taxation, there should be a separate tax for that purpose. Such taxes have already been developed in various countries; for example, Germany's *Zuwachssteuer*, which before the war had made considerable progress. Of course, the fact is that such a tax would undoubtedly be considered a direct tax in this country and would so run counter to the constitutional requirement of apportionment among the states according to population. This is a legal rather than an economic obstacle, and in my opinion does not justify a strained definition of income in order to evade the constitutional limitation upon direct taxation. The proper remedy is a constitutional amendment. States and municipalities of course are subject to no such restriction. * * *"

REMARKS OF PROFESSOR FAIRCHILD IN CONCLUDING THE DISCUSSION OF THE FEDERAL TAXATION OF INCOME AND PROFITS.

"The discussion this morning has brought out one conflict of opinion which is fundamental. This has to do with the theoretical definition of income and the distinction between income and capital. It was not my intention in this paper to bring up again any lengthy discussion of this old question. As I have already stated, this is a point upon which there has been difference of opinion among economists, and although

the matter was discussed at length at the annual meeting of this Association in 1908, it is not surprising to find that difference still persists. I was not myself present at that meeting, but my reading of its proceedings has led me to the impression that the advocates of the definition of income which I have used this morning had decidedly the better of the argument, and I am still of that opinion. For the purpose of the problem before us today we must simply recognize that a difference of opinion exists among economists as to the theoretical definition of income.

Now when we come to the practical problem before us this morning—namely, how to carry over into the field of the income tax our economic concept of income, it should of course be obvious to everyone that no theoretical concept can be applied exactly without numerous inconsistencies and difficulties, necessitating as a practical matter many qualifications and adjustments. This result will come no matter what theoretical definition we take as the starting point. That definition will be most useful in the practical problem which in the long run causes the least of such difficulties and necessitates the fewest adjustments. From this standpoint I am decidedly of the opinion that the definition of income which I have used has the distinct advantage over that definition which would include increases in capital value as income.

Professor Haig in particular has pointed out difficulties which would follow the application of my definition. In this he has been generous. He might easily have added to his list. In my study of this matter the difficulties which he mentions and many others have been foreseen. They may be generally overcome without meeting any insuperable obstacle.

But suppose we turn to the definition which he proposes. We are then immediately confronted with an overwhelming swarm of difficulties, to a very few of which I should like to call attention.

First—Gifts and inheritances should logically be included in income, with practical results which are not pleasing to contemplate.

Second—Capital frequently increases in value merely on account of the depreciation of the currency standard. To consider such increase as income is fundamentally unjust and, in extreme cases, ruinous. Complaints and petitions for relief have come in great volume from the business world on account of the injustice done from counting as income appreciation in value of assets, even in cases of annual inventories, where the matter is far less serious than when it has to do with relieving permanent capital assets. Professor Haig has suggested that this difficulty is to be met by the application of an index number correction. Others have thrown doubt upon the usefulness of this device. Personally I hope the time may come when we shall have devised some arrangement to correct the fluctuations of our monetary standard, but at best this is in the more or less distant future. What we are considering today is a present practical problem.

Third—To bring out clearly the simple principle, take A who owns a forest whose value on account of the growth of the timber is increasing at the rate of a thousand dollars a year. B receives an income of a thousand dollars a year from salary, interest or dividends. According to Professor Haig's definition of income, these two men are in the same situation and should be taxed alike. The fact is, they are not at all

in the same situation. A, during the time his forest is growing to merchantable size, receives no service from it. It yields no income, yet he is compelled to pay an annual tax, to meet which his capital furnishes him no funds. Suppose after twenty years, before any timber is cut, the forest is destroyed by fire. A has received no income under my definition. He has certainly realized nothing from the forest, and his position is the "reductio ad absurdum" of that definition which includes as income increase in value of capital assets. It is true that he could now be allowed to deduct his loss, but this he can only do to the extent to which he has income from other sources from which to make the deduction. He is granted no return of the tax paid in respect to income never received. This is an extreme case. But other cases of injustice differ from it only in degree, on account of the shorter term for which the investment runs before yielding a return. Treating as income the gain from sales of more or less long time investment has produced innumerable cases of injustice under the present law. * * *"